MCI Telecommunications Corporation
1801 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

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August 26, 1996

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: **Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996; CC Docket No. 96-150**

Dear Mr. Caton:

Enclosed herewith for filing are the original and eleven (11) copies of MCI Telecommunications Corporation's Comments regarding the above-captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Alan Buzacott

Alan Buzacott
Regulatory Analyst

Enclosure
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No. of Copies rec'd 0+11
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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FEDERAL CO[illegible] COMMISSION
OFFICE OF SECRETARY

In the Matter of:	)	
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Implementation of the	)	
Telecommunications Act of 1996:	)	**CC Docket No. 96-150**
	)	
Accounting Safeguards Under the	)	
Telecommunications Act of 1996	)	

MCI COMMENTS

Alan Buzacott
Don Sussman
MCI Telecommunications Corp.
1801 Pennsylvania Ave., NW
Washington, D.C. 20006
(202) 887-3204

August 26, 1996

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SUMMARY

MCI Telecommunications Corporation (MCI) hereby responds to the Notice of Proposed Rulemaking (Notice) initiating this docket. In the Notice, the Commission tentatively concludes that its existing Part 64 cost allocation rules generally satisfy the 1996 Act's safeguards to ensure that certain competitive services that Bell Operating Companies (BOCs) and other incumbent local exchange carriers (ILECs) are permitted to provide on an integrated basis are not subsidized by subscribers of ILEC telecommunications services for which the ILECs are dominant. The Commission also tentatively concludes that its current affiliate transactions rules, with suggested modifications, generally satisfy the 1996 Act's requirement of accounting safeguards when an ILEC conducts transactions with its affiliate.

The Commission has taken a step in the right direction by recognizing that its existing accounting safeguards must be modified to account for the increased latitude which BOCs have to enter new lines of nonregulated businesses. The existing accounting safeguards are grounded in an era in which ILEC investment in nonregulated activities and nondominant telephone services was relatively small and the Modification of Final Judgement clearly defined the businesses that BOCs were permitted to enter. The public interest clearly would not be served if the Commission adopted safeguards equal to, or less than, those upon which it relied to protect the public interest before the passage of the 1996 Act

opened the floodgates to ILEC investment in riskier nonregulated ventures, as well as additional regulated telephone services, substantially increasing the ILECs' incentive and opportunity to shift costs.

MCI agrees with the Commission's tentative conclusion that telemessaging is an information service and must therefore be provided through a separate affiliate, when offered by a BOC. MCI also agrees with the Commission's tentative conclusions concerning the cost allocation rules that will govern ILEC provision of alarm monitoring and payphone services. However, MCI recommends that the BOCs be required to provide out-of-region interLATA services through a separate affiliate regulated as a dominant carrier. In the event that a BOC provides out-of-region or other interLATA services on an integrated basis, MCI recommends modifications to the Commission's Part 64 cost allocation rules to ensure that the BOC does not cross-subsidize its interLATA services.

The Commission's existing affiliate transaction rules, without modification, do not satisfy the "arm's length" requirement of the Act. The Commission should adopt many of the proposals it first proposed in the Affiliate Transactions Notice in 1993. It should adopt a rule requiring carriers to maintain a complete audit trail of all cost allocations and affiliate transactions. MCI also supports the Commission's proposals to adopt a uniform rule for valuing transfers of assets and services and eliminate the use of prevailing company price. Furthermore, the Commission should adopt the rule proposed in the Affiliate Transactions

Notice, requiring the BOCs to record affiliate transactions at tariffed rates if they are provided pursuant to tariffs that are generally available, on file with a federal or state agency, and in effect. The "generally available" requirement would reduce the incentive for the BOCs to use Individual Case Basis (ICB) tariffs to favor their own affiliates.

Tariff-based valuation does not, by itself, fully comply with the arm's length requirement of the Act. An intracorporate purchase of access at tariffed rates — the "imputation" requirement — is a meaningless safeguard as long as access is priced significantly over cost, as it is now. Unless the interLATA affiliate's rates or earnings cover its access and all other costs, requiring it to pay the BOC tariffed rates for access will be a meaningless intracorporate accounting fig leaf and will not prevent anticompetitive pricing and cross-subsidization. Without a process of reviewing the affiliate's rates or earnings, requiring the sale of services to the affiliate at tariffed rates is an empty requirement.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Implementation of the	)	
Telecommunications Act of 1996:	)	**CC Docket No. 96-150**
	)	
Accounting Safeguards Under the	)	
Telecommunications Act of 1996	)	

MCI COMMENTS

I. Introduction

MCI Telecommunications Corporation (MCI) hereby responds to the Notice of Proposed Rulemaking (Notice) initiating this docket.[1] The Notice addresses accounting safeguards that would apply when an incumbent local exchange carrier (ILEC), including a Bell Operating Company (BOC), provides the services addressed in Sections 260 and 271 through 276 of the 1996 Act.[2] These sections delineate the conditions under which ILECs may offer telemessaging and alarm monitoring services and BOCs may manufacture and

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[1] Implementation of the Telecommunications Act of 1996; Accounting Safeguards Under the Telecommunications Act of 1996, CC Docket No. 96-150 FCC 96-309 (released July 18, 1996).

[2] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996 Act) to be codified at 47 U.S.C. §§ 151 et seq. The 1996 Act amended the Communications Act of 1934 (Communications Act).

sell telecommunications equipment, manufacture customer premises equipment, and offer interLATA telecommunications, information, electronic publishing, and payphone services. The Notice considers accounting safeguards that are intended to protect subscribers to regulated monopoly services provided by the BOCs and, in some cases, other ILECs against the risk of being forced to "foot the bill" for the carriers' entry into, or continued participation in, competitive services, and to promote competition in new markets by preventing carriers from using their existing market power in local exchange services to obtain an anticompetitive advantage in those new markets the carriers seek to enter.[3]

In the Notice, the Commission tentatively concludes that its existing Part 64 cost allocation rules generally satisfy the 1996 Act's requirement of safeguards to ensure that certain interLATA telecommunications and information, alarm monitoring, and payphone services that BOCs and other ILECs are permitted to provide on an integrated basis are not subsidized by subscribers of ILEC telecommunications services for which the ILECs are dominant.[4] The Commission also tentatively concludes that its current affiliate transactions rules, with suggested modifications, generally satisfy the 1996 Act's

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[3]Notice at ¶4.

[4]Notice at ¶26.

requirement of accounting safeguards when an ILEC conducts transactions with its affiliate.[5]

The Commission has taken a step in the right direction by recognizing that its existing accounting safeguards must be modified to account for the increased latitude which BOCs have to enter new lines of nonregulated businesses. The existing accounting safeguards are grounded in an era in which ILEC investment in nonregulated activities and nondominant telephone services was relatively small and the Modification of Final Judgment[6] clearly defined the businesses that BOCs were permitted to enter.[7] The public interest clearly would not be served if the Commission adopted safeguards equal to, or less than, those upon which it relied to protect the public interest before passage of the 1996 Act opened the floodgates to ILEC investment in riskier nonregulated ventures, as well as

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[5]Id.

[6]United States v. Western Elec. Co., 552 F. Supp. 131 (D.D.C. 1982), aff'd sub nom., Maryland v. United States, 460 U.S. 1001 (1983).

[7]Existing rules were developed in the Joint Cost and Computer III proceedings to help ensure that ratepayers would not bear the costs and risks of the telephone companies' nonregulated activities. Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298, 1312-14 & 1335 (1987)(Joint Cost Order), recon 3 FCC Rcd 6701 (1988), aff'd sub nom, Southwestern Bell Corp. v. FCC, 896 F. 1378 (D.C. Cir. 1990). Amendment of Section 64.702 of the Commission's Rules and Regulations, CC Docket No. 85-229, Phase I, 104 FCC 2d 958, 1039-42 (1986)(Computer III Order), on reconsideration, 2 FCC Rcd 3035 (1987); Phase II, 2 FCC Rcd 3072 (1987) (collectively, Computer III Orders), vacated and remanded sub nom., California v. FCC, 905 F.2d 1217 (9th Cir. 1990).

additional regulated telephone services, substantially increasing the ILECs' incentive and opportunity to shift costs.

II. The BOCs Have the Incentive and Ability to Cross-Subsidize

The 1996 Act prescribes specific safeguards that will govern the provision of competitive services by the BOCs. MCI agrees that these provisions of the Act show that Congress recognized that BOC entry into in-region interLATA services, manufacturing, and other areas raises serious concerns for consumers and competition, even after a BOC has satisfied the requirements for entry.[8] These concerns are due to the BOCs' continuing market power in the local exchange and exchange access markets, which gives them the ability to cross-subsidize their new competitive ventures.

It is undeniable that the BOCs and other ILECs still retain overwhelming market dominance in the local exchange and access markets within their service territories. According to the Notice, the BOCs control a 99.5 percent share of the local exchange and exchange access markets.[9] Furthermore, the bottleneck control enjoyed by the ILECs will not evaporate overnight. Although the 1996 Act lays the groundwork for the development of local competition, there are many steps that have yet to be taken before ILECs face effective competition.

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[8] Notice at ¶6.

[9] Id.

The Commission has characterized the recent Local Competition Order as only the first part of a "trilogy" that also includes universal service reform and access reform.[10] In addition, significant issues remain to be addressed in the context of state arbitrations of Section 251 negotiations.

The monopoly power that the BOCs and other ILECs continue to enjoy gives them the ability to subsidize their competitive activities with monopoly revenues and to engage in other forms of discrimination. The ILECs have the ability to recover costs incurred in the provision of competitive services from their captive local exchange and exchange access customers. This cost shifting can occur either through misallocation of costs between regulated and nonregulated activities, or through improper valuation of transactions between an ILEC and affiliates engaged in competitive activities.

Price caps have not eliminated the incentive for the ILECs to shift costs to their competitive activities. Price cap LECs may choose to be subject to sharing each year, which generates incentives to reduce their reported rate of return by shifting costs to their local exchange and exchange access operations. Even if the Commission were to implement a "pure" price cap regime that did not use a sharing mechanism, the relationship between ILECs' reported rate of return and future adjustments to the productivity factor is itself a sufficient linkage to cause

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[10] In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, CC Docket No. 96-98, August 8, 1996 (Local Competition Order) at 9.

an ILEC to manipulate its reported earnings by cost shifting. Moreover, the majority of states continue to rely on either rate of return regulation or price cap plans that incorporate sharing mechanisms, which creates incentives to shift costs to the BOCs' monopoly local exchange and exchange access operations.

Congress clearly recognized the incentives for ILECs to shift costs between their new competitive activities and their monopoly local exchange and exchange operations. In particular, the separate affiliate requirement governing BOC provision of in-region interLATA telecommunications services, interLATA information services, and manufacturing services indicates that Congress was aware of the substantial risks that accompany BOC provision of these services. The rules adopted in this proceeding must give full force to each of the prohibitions against cross-subsidization contained in the 1996 Act, especially the requirement that all transactions between the BOCs and their separate affiliates be valued as if they had been conducted at "arm's length."

III. Recent State and Federal Audits Highlight the Need for Stronger Accounting Safeguards

Several recent critical audits of ILEC affiliate transactions conducted by state and federal authorities highlight the inability of the Commission's existing safeguards to discourage cost shifting, even in a pre-1996 environment of fewer ILEC competitive opportunities. For example, in April 1994, the Commission and the GTE Telephone Companies (GTOCs) entered into a Consent Decree settling issues arising out of an audit of the transactions between the GTOCs and two of their nonregulated affiliates. The audit revealed that the nonregulated affiliates achieved excessive rates of return in their sales of services to the GTOCs and that the resulting excessive costs to the GTOCs were passed on to ratepayers. The terms of the Consent Decree required the GTOCs to file rate reductions, make a contribution to the United States Treasury and undertake other remedial actions.[11] Similar findings as to excessive nonregulated affiliate earnings were made in an earlier audit of transactions between BellSouth Corporation's operating companies and a nonregulated subsidiary.[12]

A month after the GTOC Consent Decree was entered, the Commission released a federal-state joint audit examining transactions between Southwestern Bell Telephone Company (SWBT) and various of its affiliates, including its parent, Southwestern Bell Corporation (SBC). The audit report found a lack of supporting documentation for time charged by SBC employees for work done for SWBT, use of an improper marketing allocator and improper use of the general allocator. The report also found that certain services provided by SBC to SWBT were improperly charged at a prevailing company rate that did not reflect actual costs. The Commission accordingly issued an Order to Show

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[11]Consent Decree Order, The GTE Telephone Operating Companies, AAD 94-35, FCC 94-15 (released April 8, 1994).

[12]BellSouth Affiliate Transaction Audit: Summary of Audit Findings (undated). See BellSouth Corporation, et al., AAD 93-127, FCC 93-487 (released Oct. 29, 1993).

Cause why SWBT should not be found to have violated the affiliate transaction and cost allocation rules and appropriate enforcement action taken.[13]

On the same day that it issued the SBC show cause order, the Commission released six other show cause orders.[14] According to the International Communications Association, the apparent violations listed in these orders cost ratepayers at least $73.5 million dollars, not including the effects of shifts between the Common Line and other categories nor including the value of 19 violations for which the Commission could not calculate a value.[15]

Subsequently, the Commission entered into a Consent Decree settling issues arising out of a joint federal-state audit of the transactions between the Ameritech Operating Companies (AOCs) and their affiliate, Ameritech Services, Inc. (ASI). The Joint Audit Report concluded that ASI failed to provide adequate

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[13]Southwestern Bell Telephone Co., AAD 95-32, FCC 95-31 (released March 3, 1995)(SWB Audit).

[14]Ameritech Telephone Operating Cos., AAD 93-147, FCC 95-72, Order to Show Cause (released March 3, 1995); Bell Atlantic Telephone Operating Cos., AAD 93-147, FCC 95-73, Order to Show Cause (released March 3, 1995); BellSouth Telephone Operating Cos., AAD 96-148, FCC 95-74, Order to Show Cause (released March 3, 1995); NYNEX Telephone Operating Cos., AAD 93-149, FCC 95-75, Order to Show Cause (released March 3, 1995); Pacific Bell, AAD 93-150, FCC 95-76, Order to Show Cause (released March 3, 1995); Southwestern Bell Telephone Co., AAD 93-151, FCC 95-77, Order to Show Cause (released March 3, 1995); US West Communications, Inc., AAD 93-152, FCC 95-78, Order to Show Cause (released March 3, 1995).

[15]Ex parte letter from Brian Moir, Attorney for the International Communications Association, to William F. Caton, Acting Secretary, Federal Communications Commission, October 20, 1993.

documentation to support the assignment of many costs to the AOCs and other affiliates. The Report also alleged that certain misclassifications of costs by ASI resulted in overallocation of costs to regulated ratepayers. Under the Consent Decree, ASI agreed to make certain changes in its accounting practices and payments to the United States Treasury and to the states of Ohio and Wisconsin.[16]

These audit reports demonstrate that ILECs continue to have the incentive to shift costs, even those ILECs that operate under price cap regulation. The audit reports also clearly demonstrate the difficulties inherent in relying on audits to detect violations of the Commission's cost allocation and affiliate transactions rules. The audit reports cited above consistently found that the ILEC had failed to maintain records or provide documentation that would allow auditors to analyze its books. Because Commission enforcement of accounting rules relies heavily on effective audits, ILEC unwillingness to provide sufficient documentation undermines the rules themselves. Accordingly, the Commission should adopt a rule requiring carriers to maintain a complete audit trail of all cost allocations and affiliate transactions, as was proposed in the Affiliate Transactions Notice in 1993.[17]

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[16]Consent Decree Order, Ameritech, AAD 95-75, FCC 95-223 (released June 23, 1995) (Ameritech Consent Order).

[17]In the Matter of Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, 8 FCC Rcd 8071 (Affiliate Transactions Notice) at

The audit reports also demonstrate that cost allocation and other rules are only as good as the Commission's willingness and ability to enforce them with sufficient penalties to inhibit future misallocations. This final link in the chain may be the weakest of all. Most recently, the Commission released a summary of its audit of the BOCs' accounting for lobbying costs, which found $116.5 million in misclassified lobbying costs during the period from 1988 through 1991.[18] Moreover, the inflated access rates resulting from such misallocations were carried over into the ILECs' access rates under price cap regulation. In spite of these egregious violations, the Commission failed to take any enforcement action for the past ratepayer injuries resulting from these misallocations.[19] Its failure to take such enforcement action confirms the inadequacy of the entire cost accounting regulation and audit function, since the ILECs apparently have a "free shot" at any accounting violation they may wish to commit, knowing that the worst that can happen is that someday, if they are caught, they might have to correct such practices only on a going-forward basis.

8105.

[18]Commission Releases Summary of Lobbying Costs Audit Findings, Report No. CC Docket No. 95-65 (released Oct. 26, 1995).

[19]See id.

IV. Accounting Safeguards For Integrated Operations

In the Notice, the Commission tentatively concludes that its existing Part 64 cost allocation rules generally satisfy the 1996 Act's requirement of safeguards to ensure that certain interLATA telecommunications and information, alarm monitoring, and payphone services that BOC and other ILECs are permitted to provide on an integrated basis are not subsidized by subscribers to regulated telecommunications services.[20] While MCI supports many of Commission's interpretations of the 1996 Act, MCI recommends that the Commission prescribe added safeguards to protect the public interest.

A. Telemessaging Services Are Governed by The Separate Affiliate And Other Requirements of Section 272

In the Notice, the Commission tentatively concludes that the category of "telemessaging services," as defined in Section 260(c), falls within the overall category of information services and is thus governed by the separate affiliate and other requirements of Section 272. MCI agrees with this tentative conclusion.

The Commission should require BOCs that currently provide telemessaging service on an integrated basis to remove all related costs from

[20] Notice at ¶26.

their Part 32 Universal System of Accounts (USOA).[21] These BOCs must remove all embedded costs related to telemessaging, including any common or shared costs, from their Part 32 accounts. This is the only way to ensure that telemessaging is not subsidized by other services, and is necessary to comply with the Commission's correct interpretation that telemessaging is an information service and, therefore, subject to the separate affiliate requirement.

B. BOC Out-Of-Region InterLATA Service Should Be Provided Through Separate Affiliates

There is a wide range of possible cost-shifting and discrimination that can result from ILEC provision of out-of-region interexchange services on an integrated basis. Many of these cross-subsidies involve company-wide costs that, by their nature, are common to local exchange and out-of-region interexchange services, are hard to detect, and are not deterred by price cap regulation.

In its BOC Out-of-Region Comments,[22] which are incorporated by reference herein, MCI demonstrated that, due to the BOCs' continuing local bottleneck control and their ability to apply that control out of region in the

[21]According to the Notice, Bell Atlantic, BellSouth, Ameritech, NYNEX, and U S West currently provide telemessaging service through their regulated telecommunications carrier.

[22]Comments of MCI Telecommunications Corporation, Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Service, CC Docket No. 96-21, filed March 13, 1996 (BOC Out-of-Region Comments).

interLATA market, their out-of-region interLATA services should be provided only through separate affiliates and should be regulated as dominant carrier services. These BOC separate affiliates should be subject to the stringent conditions proposed in MCI's BOC Out-of-Region Comments. Non-BOC ILECs should continue to be subject to the current Competitive Carrier[23] separation rules, both in- and out-of-region.

However, in the event that a BOC provides out-of-region or other interLATA services on an integrated basis, the Commission must ensure that the BOC does not cross-subsidize its interLATA services. In the Notice, the Commission tentatively concludes that it should apply its cost allocation rules to regulated services other than local exchange and exchange access services.[24] The Notice then asks whether the Commission should require BOCs to create a separate category for these regulated services within their internal cost allocation

[23]Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Therefor, CC Docket No. 79-252, Notice of Inquiry and Proposed Rulemaking (Notice), 77 FCC 2d 308 (1979); First Report and Order (First Report), 85 FCC 2d 1(1980); Further Notice of Proposed Rulemaking, 84 FCC 2d 445 (1981); Second Further Notice of Proposed Rulemaking, 47 Fed. Reg. 17308 (1982); Second Report and Order (Second Report), 91 FCC 2d 59 (1982), recon. denied, 93 FCC 2d 54 (1983); Third Report and Order (Third Report), 48 Fed. Reg. 46791 (1983); Fourth Report and Order (Fourth Report), 95 FCC 2d 554 (1983), vacated, AT&T v. FCC, 978 F.2d 727 (D.C. Cir. 1992), cert. denied, MCI Telecommunications Corp. v. AT&T, 113 S. Ct. 3020 (1993); Fourth Further Notice of Proposed Rulemaking, 96 FCC 2d 1191 (1984); Fifth Report and Order (Fifth Report), 98 FCC 2d 1191 (1984); Sixth Report and Order (Sixth Report), 99 FCC 2d 1020 (1985), vacated sub nom., MCI Telecommunications Corp. v FCC, 765 F.2d 1186 (D.C. Cir. 1985).

[24]Notice at ¶39.

systems, or if it should require BOCs to classify these services as nonregulated for Title II accounting purposes.[25]

The Commission should not simply treat the BOCs' interLATA operations as unregulated for Title II accounting purposes. Because the potential for cross-subsidy between local and interLATA services is significant,[26] and because of the need to police the imputation of access charges required by the Act,[27] it is essential that the Commission be able to monitor separately the costs allocated to interLATA services. The Commission should adopt its proposal to create subsidiary accounts for interLATA services, following the model established with respect to video dialtone. This would permit the Commission to better track the allocation of costs between a BOC's local and interLATA operations, and assist in ensuring that local exchange and exchange access ratepayers are not cross-subsidizing BOC entry into long distance.

C. Alarm Monitoring Services Should Be Treated As Nonregulated Activities

Commission rules require carriers to treat alarm monitoring services as nonregulated activities for Title II accounting purposes. Accordingly, the Part 64 cost allocation rules require ILECs to allocate the costs of those services to

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[25] Id.

[26] See MCI BOC Out-of Region Comments at 7-12.

[27] 47 U.S.C. §272(e)(3).

nonregulated activities. MCI agrees that alarm monitoring services should be subject to Part 64 cost allocation rules.

D. Payphone Services

The 1996 Act requires that, at a minimum, the Commission impose nonstructural separations rules on the BOCs' payphone services equal to those adopted in Computer III, which the Commission proposes to do. The Court, however, has remanded the Commission's Order adopting the Computer III safeguards for further consideration because the Commission failed to provide support for some of its material conclusions regarding the ability of the safeguards to prevent discrimination.[28] Thus, any revisions to the safeguards or new safeguards adopted in the remand proceeding[29] -- including modifications which would require separate affiliates -- should also apply to the BOCs' provision of payphone service. It was clearly Congress's intent to follow the Computer III rules, whatever form they ultimately take. These accounting safeguards should be applied to all ILECs since no distinctions exist in the manner ILECs and BOCs recover costs, provide payphone service, or control bottleneck facilities.

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[28] California v. FCC, 39 F.3d 919 (9th Cir. 1994).

[29] Computer III Further Remand Proceeding: Bell Operating Company Provision of Enhanced Services, Notice of Proposed Rulemaking, CC Docket No. 95-20, 10 FCC Rcd. 8360(1995).

V. Section 272 Safeguards for Separate Operations

Section 272 of the 1996 Act requires that all transactions between a BOC and its interLATA telecommunications, interLATA information services, and manufacturing affiliates be on an arm's length and nondiscriminatory basis. In the Notice, the Commission solicits comments on the accounting safeguards that are required to enforce the arm's length and nondiscrimination requirements, and tentatively concludes that its existing affiliate transactions rules generally satisfy the statute. The Commission also invites comments on whether it should amend the existing affiliate transactions rules to incorporate several of the modifications that it proposed in the Affiliate Transactions Notice in 1993.

The Commission's existing affiliate transaction rules, without modification, do not satisfy the "arm's length" requirement of the Act. The BOCs will be entering large markets where even small changes in the valuation of affiliate transactions can have a significant aggregate effect on BOC captive ratepayers, and the importance of these new markets will create significant incentives for the BOCs to cross-subsidize. The existing rules give the BOCs too much latitude in valuing their affiliate transactions. The rules adopted in this proceeding must prescribe with greater specificity the methodology that the BOCs are to follow in recording affiliate transactions on their regulated books.

Moreover, the 1996 Act contains several specific requirements that mandate modification of the existing affiliate transaction rules. In particular, the Act requires all transactions to be reduced to writing and available for public inspection.[30] The Act also requires BOCs to make available for public inspection information concerning its affiliates' requests for local exchange and exchange access services. Finally, the affiliate transactions rules must recognize the unique requirements of transactions between BOCs and their interLATA affiliates, which will be regulated under Title II of the Communications Act.

A. Accounting Requirements of Sections 272(b)(2) and (c)(2)

Section 272(b)(2) of the 1996 Act requires the BOCs' interLATA telecommunications, interLATA information services, and manufacturing affiliates to "maintain books, records, and accounts in the manner prescribed by the Commission." The Commission solicits comments on the steps it should take to implement this provision.[31]

The Commission should require the BOCs' nonregulated manufacturing and interLATA information services affiliates to maintain their books in accordance with Generally Accepted Accounting Principles (GAAP). However, the Commission should require the BOCs' interLATA telecommunications affiliates to maintain their books pursuant to the Part 32 Uniform System of Accounts (USOA). Because these affiliates will be regulated under Title II of the Communications Act, the Commission must maintain its ability to exercise its

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[30]47 U.S.C. 272(b)(5)

[31]Notice at ¶33.

Title II authority by imposing its own accounting rules. Under certain circumstances, regulatory accounting may be required to deviate from GAAP in order to protect ratepayers.

Moreover, standardization of Part 32 accounting between a BOC and its in-region interLATA affiliate facilitates earnings comparisons, as well as comparisons of investment and expenses. This benchmarking is critical to the Commission's ability to identify instances where a BOC is possibly cross-subsidizing an interLATA affiliate. The Commission could use the information gained from such analysis of the interLATA affiliate's books to plan its audit schedule, for example.

To the extent that BOC interLATA operations are one day permitted to merge with exchange operations, the Part 32 accounting requirement will assist regulators in understanding the effects of removing the separate affiliate requirement and in ensuring that no unexpected effects occur due to differences in accounting. Part 32 accounting is also necessary for the BOCs' interLATA affiliates to determine Part 36 separations accounts. The Commission needs to understand the impact that a merged exchange/interLATA offering would have on jurisdictional separations results. Since the separations rules utilize allocators based on usage, it is highly likely that the BOCs' interexchange operations will produce a shift in their jurisdictional revenue requirements. Even in a regulatory system such as price caps, revenue requirements play a key role in sharing